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Cost and Management

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Editorial Comment . . .

Business Games

SINCE the dawn of civilization, man has been constantly probing the unknown, perceiving new concepts and discovering new and ingenious means of creating devices or accomplishing feats of massive proportion.

The products of man's intelligence were never more evident than in this age of ours. Hardly a week passes but one is confronted with a breakthrough in the sciences, a new technique in the business world or a different mode in the arts. Overnight, a discovery catches the imagination and becomes a panacea for all the ills in that field of endeavour, but time often proves many innovations only a partial cure or of no help at all.

One of the more recent designs received with enthusiasm for use in training businessmen for their command performance as top executives is the business game. Since this is a relatively new idea in the management development field, it still has to pass the test of time before it proves its practical worth. It would be wrong to censure a new idea such as this, since very often the lunatic fantasy of today becomes the signpost of tomorrow. However, it may be well to offer a word of caution on the use of business games. If the intention of their advocates is kept in mind and a limit placed on the possibilities of their use, then a perspective is drawn in which the results obtained may be rewarding.

Business games were developed to fill a need in the business world. Top executives in the complex maze of industrial inter-relationships require the attributes of an intellectual but practical giant. The scope and judgment requirements are difficult, if not impossible, to acquire at the operational level. Thus, the business game was designed to simulate the industrial amphitheatre and give the executive a chance to

try his hand at guiding the affairs of an enterprise without having to meet the actual consequences of poor judgment and failure that spell disaster in the stark realism of competitive practice.

Business games are much the same as the game of *Monopoly*. However, there is a closer similarity to the actual business field, and the players have to exercise more tempered judgments than if they were playing the game of fun where you take a gamble and hope for luck.

The principle of the business game is such that the players are directly responsible for as many results as possible and probability determines the remainder. The closer the game approaches realism, the longer it becomes, then fewer of the results are caused by luck. A by-product of this realism is less playability and more time consumption. The game may be set up with many variations, but in each case it is played against one or more competitors with umpires to set the business atmosphere, furnish information and interpret the decisions of the contestants. Certain elements are determined before starting when the various activities such as production or finance are set, with the emphasis placed on whatever area it is desirable to exploit. The business atmosphere such as market and competition is also determined. However, the game is not static, that is, conditions such as markets, and potentials such as production can and do change as the players engage in the competitive dealings.

This method of teaching has long been used successfully by the military to teach combat tactics to officers in training. However, one must remember that the armed services have areas set aside for this purpose and that they have vast resources to simulate conflict conditions. More important, the participants are in training; they are not spending eight hours a day fighting and one hour playing in a mock battle.

Possibly the biggest drawback to the business game is that most industrial enterprises will find it difficult to organize. It will be even more difficult to find a time suitable to the required number of contestants and umpires. Undoubtedly it will require the backing of top management and may even become a part of company policy before it will meet with any success. If business games were operated by some outside agency such as a business school where industry could send executives at intervals for a few days at a time, this aid to learning may meet with more success since it would be less disrupting to other areas within the organization.

The demands on the top executive echelon seem to be ever increasing. The type of man required to fill these posts is difficult to find and very often does not stand the strain of the many demands on his energy. In preparation for these positions there is likely no substitute for a good basic and formal education given in the schools and colleges. However, a man should never stop learning: education is a continuing process. He will learn from actually engaging in the business world, from management training programs, and from many unlikely sources that broaden his outlook or in some small way adds to his storehouse of knowledge. It is in this area, perhaps, that the business game will find its place. It will be another tool that management can use to further its capabilities in the executive area. It will not replace the older methods of instruction or learning because in order to be able to play the game with intelligence, one must have assimilated knowledge and have had a certain amount of familiarity with the reality of practice. It is a fresh approach, and it will be interesting to see how industrial leaders will grasp this new device and play the game.

CONTROL BY DIRECT COST METHODS IN THE FURNITURE INDUSTRY*

By F. M. Rabjohn,
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Many advantages are secured, according to the author, by the use of direct cost methods in the furniture industry. Drawing upon much of the information available in the present standard cost system, he outlines here a hypothetical application of a direct cost system which will be particularly useful to the small furniture manufacturer. The system is designed to provide management with a simple, efficient and readily effective plan of cost control that requires very little clerical effort.

IN APPLYING the principles of direct costing to the furniture industry, I have drawn heavily on the information and controls accessible in the standard cost system now in use at the plant which I have been privileged to observe. In many ways, the existing system is excellent. The material and labour controls it provides come little short of perfection. The main fault seems to be that it emphasizes the wrong phase. Too often a brilliant production record has accomplished only that, the final profit remaining entirely inconsistent with the daily and weekly results portrayed. How endless were the explanations and reconciliations of a statement that showed at the same time unequalled success and dismal failure! Surely somewhere, a simple projection of existing conditions could be accomplished and the goal stated clearly and concisely.

Because of this problem, the turn to direct cost was taken. It may in the long run create even darker problems. It may be unadaptable to large plants with even production and adequate storage. It is my belief, however, that the small manufacturer, burdened with inadequate storage and faced with a constantly shifting market and production program, could receive from this cost approach a clarity and definition of current and future activity far in advance of the normal methods.

Small businesses are run by sincere, hardworking and often harried men. They are not trained to study or analyze detailed accounting statements. The message must be clear-cut, brief, brilliant, explosive if necessary. It must be stated with the boldness of the headline, the impact of the cannon ball. I believe direct costing will do just that.

*Condensation of a thesis submitted for R.I.A. qualification.

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THE FURNITURE INDUSTRY

The owner or manager of a furniture factory soon realizes that he is dealing with an extremely difficult product. In times of prosperity style follows style with bewildering rapidity, while in times of scarcity the market falls off as the home economy is diverted more to the appliance and TV market.

Of late years, there has been a growing tendency towards the import or manufacture in Canada of attractively styled, low-priced merchandise. The advantages of this type of product are numerous. It comes selected, tested on the U.S. market, the engineering and cost perfected before manufacturing is attempted in Canada. Backed by national advertising, this product is becoming a serious threat to the Canadian furniture manufacturer, representing as it does the extension of American industry and methods in our country.

Confronted with these problems, the life of the small Canadian manufacturer can indeed become complex. His best defence is, of course, offence. He must be flexible, quick to change with the current trend and to take advantage of every loophole, ever watchful, ever ready to gain and hold the public confidence by superior design, high quality and above all, prompt and efficient service. He must convey the idea that his plant is designed and maintained to look after the needs of the Canadian people, having regard for their special background and outlook. Further, the more personal approach of the smaller concern is conducive to higher quality and sustained customer satisfaction through prompt deliveries, the direct result of close co-operation between sales and production.

The emphasis in management, then, must come on flexibility, efficiency and economy. Only through flexibility can the fleeting market be captured, only through efficiency can promised deliveries be maintained and only through economy can a high standard of quality be presented at low cost.

Readily available to the small manufacturer must be information for the prompt establishment of a price, information regarding the efficiency of the operation and information relative to marginal costing. This must be ever present so that decisions can be made instantly based on sound facts and geared to the immediate needs of the organization.

These prime requirements may seem the essence of simplicity but circumstances render them often very difficult to obtain, too late when available and sometimes of doubtful worth.

One of the difficulties is the lack of a straight run production in the average plant. Under present conditions of an instant market and an eight to twelve-week production, it is inevitable that some errors are made in calculating requirements. With materializing sales lower or in excess of the original plan, certain items must be dropped and others emphasized in production. This causes inventories at points not experienced in straight line production. There is too, the matter of color and finish. The manufacturer runs through an entire cutting in one color at his peril. The market will demand something new. The result is—inventory storage at an intermediary point.

In such circumstances, control is difficult. Because of the production time element, changes in product demand and market vagaries, production is seldom matched with sales. The problem of inventory valuation and control through cost

administration is rendered doubly difficult. For this reason, it would appear that a system recognizing the prime difficulties of this type of manufacture, placing first emphasis on product disposition and able to point out the weak points in the existing program together with the availability of marginal facilities, would be of great value. It would therefore appear that in the furniture industry, direct costing would be applicable and bear further investigation.

THE DIRECT COST SYSTEM

Production in the average furniture plant falls naturally into three divisions: the machine, cabinet and finishing rooms. These main groups are comprised of a number of subsidiary departments which provide natural cost centres marking the progress of work from the raw material to the completed stage.

The major part of the capital cost is centred in the machine room. Along with the drying kilns and veneer room equipment, this presents the largest portion of the direct cost. This condition is further aggravated by the fact that not all the machines are used in the manufacture of every type of product, but some stand idle for long periods until they are needed in a particular process. The remaining departments, cabinet and finishing, do not have this problem to the same extent. With minor exceptions, the equipment is used in all production.

In general, the in-process inventory remains in pieces through the machine room and is assembled in the cabinet room. The finishing, rubbing and hardware attachment is done in the finishing room. Should the original plans be altered, it is desirable to store inventory unassembled rather than permit it to carry into the cabinet room. After assembly, the bulk and vulnerability of the article makes storage doubly difficult. It is advisable, then, to have a portion of stock stored in the white at all times. Whereas four or five weeks are required to get it to this stage, only one week in the finishing room is needed to complete the product. The desirable condition, of course, would be to carry on a straight line production from raw material to finished stages. Unfortunately, most small manufacturers find this is seldom possible. Every cutting, of even reasonable amounts, must be held in part at intermediate points awaiting the trend in the market or acceptance of some new color before it is passed on to ultimate disposal.

In the finishing room the assembled suites are put through in batches dictated by the orders for colors or finishes. If storage is necessary, it should be done at the pre-rubbed stage. In this condition the furniture is not so vulnerable to marks and scratches. Moreover, each order can be hand-rubbed and shipped within a day and the customer is assured of a perfect finish.

Changing market conditions make an increasing amount of inventory necessary, stored at many points. This has caused considerable trouble with the reports of normal cost systems and is one of the reasons for the adoption of the direct cost approach.

In most cases, furniture factories are operated under the standard cost system. A few, devoted to the production of a modern type of suite under a single cutting output, adhere to the job costing technique. In each of these the cost emphasizes, and resulting reports to management stress, production. While this is quite correct, the fact that sales must in the long run absorb the costs of production is overlooked

and often the insidious inventory increase at various points is not emphatically apparent until too late.

At this point, the problem of inventory valuation arises. Where the storage of inventory (often in small pieces) at various stages becomes common, management is reluctant to include all charges. Thus up to the point of assembly, material only is charged; at that point on, material and labor. Overhead is then added, only at the finished stage. The difficulty in controlling the operation and reporting the efficiency of each department under these conditions may well be imagined.

It would seem then that complete control, under these conditions, could better be maintained by the use of the direct cost system.

This system gives permanent recognition to the fixed charges and the duty of sales alone to overcome them. It will result in correct valuation of inventory in whatever position in the plant it has been stored pending further developments. Most important, it will give the definite amount contributed to fixed cost (and profits) for each type of product.

With the contribution of each sales section known and the amount necessary to cover the fixed charges stated, management can go on to organize sales along the most desirable lines. Furniture products lend themselves particularly to this type of costing. The maximum selling price applicable is invariably known; the material, labor and variable burden costs can be completed with reasonable accuracy. The difference, in per cent and amount, can then be shown as a contribution to the fixed manufacturing and other costs. Management is then fully aware of the benefit or harm of each project.

Should it be necessary to shelve an article because of unfavorable sales, the responsibility of covering the fixed charges is clearly placed at the door of sales and they must, in their plan, substitute other shipments having a contributory factor in excess of fixed costs if profitable results are to be maintained.

The direct cost system can be easily developed from material used in the standard cost system. The reports to production will include analyses of material usage variances waste factors, labor efficiency and rate variances, and factory burden efficiency. The main reports to sales will show contribution by product in per cent to operating and disposition costs; those to management will provide break even and profit volume analysis, together with reports on plant operation compared to capacity.

In this way production is provided with sufficient information to ensure plant efficiency, sales with adequate light to emphasize the desirable product and management with the required knowledge to decide on marginal contracts or other courses of action.

The great hazard of the furniture industry, fixed costs, is featured under this method. The emphasis on sales, and sales alone, to overcome this danger is stated in sufficient clarity to convince the most indifferent. Inventories may be accurately stated at any stage of completion without fear of overstating their value and the production of the plant can be accurately measured and assessed.

ORGANIZATION

The questions of what to make, when to make it and in what quantities spell the initial establishment of organization. Behind this organization loom the fixed charges

of the organization, providing a setting for the activity which they support and which, in turn, must be absorbed.

The product question is of primary importance. This is handled by a committee composed of the general manager, designer, sales manager and plant superintendent. The questions to be decided are many and varied but generally can be channelled into the classifications of product, quantity, and time. Normally this committee meets only once or twice a year to draw up general policy with possibly one or two subsequent meetings to clarify problems arising from prior decisions. At these meetings the problems of product mix, varied contributions of different products and the time available for marginal cost production will be covered.

Once the preliminary planning is done, the budget committee must reduce the plan to a forecast from the sales, production, inventory and financial aspects. This provides the structure for establishing production and financial needs. Before the forecast is determined, a series of meetings gradually enlarging on the topics as they are clarified, will probably be held. As in the previous meetings, the general manager represents co-ordination, the controller represents finance and the sales manager, market and plant superintendents represent the product aspect of the budget.

The outcome of the entire planning is a series of cutting orders. These represent the disposal problem of the sales department and the production problem of the plant superintendent. Though an entire year's production may not be determinable at any given moment, successive meetings will produce a reasonable forecast for the immediate future. The focal points of the entire procedure are the fixed charges and the contribution to profit. Upon the completion of each unit cost, the contribution of this will be known. It will be the duty of the general manager to confer with sales and production constantly to alter plans, take other work or, on occasion, to halt the flow of certain work or restrict certain production as the vagaries of the market become known.

One of the great problems of the small manufacturer centres around the necessity for complete flexibility. Co-ordination of production and sales must be achieved at all times and this is greatly assisted by the direct cost approach. The question is no longer one of what can we produce at greatest efficiency but what can our plant fabricate and sell in return for dollars to cover fixed expenses, provide profit and improve the financial condition.

The plans now consolidated but ever flexible, the procedure goes through the drawing, costing and pricing of each unit, requisitioning and purchasing of materials, employment of labor and production planning throughout the plant.

The organization is arranged so that the results of engineering and planning are tabulated and reported by the cost department. Control reports for efficiency on the operating levels and reports co-ordinating sales and production efforts to the administrative levels are provided.

The general divisions of sales, production and finance, headed by the sales manager, plant superintendent and comptroller respectively, are provided with control reports of their divisions. The essential co-ordination is emphasized in the final statements and analyses showing the results of the effort from the direct cost standpoint.

One important feature is the quality control of the finished product under sales. In this business, a satisfied customer and an acceptable product are fundamental. For this reason the sales manager is the final authority on quality and the plant must produce goods acceptable to him and to the market he is trying to enlarge or create.

Having established the theoretical production and the organization and control of plant activities, it is my intention to explore each aspect of production and production planning. The results of these steps will be utilized in the final result, management planning.

ACCOUNTING PROCEDURE

The main aim in general accounting is to provide a basic simplicity of operation that will reduce clerical help to the minimum and provide sufficient analysis for the establishment of control.

With this in mind, the chart of accounts was drawn up to include only those accounts necessary for clarity and to provide the grouping necessary for proper balance sheet analysis. The chart provides for the accrual of expenses which is essential under the present system, using the calendar month as the accounting period.

The main divisions of the chart take in the balance sheet items, inventory, direct labor, manufacturing expenses, selling and warehousing, administrative and other expenses. Each of these divisions is maintained in control form in the general ledger and the segregation followed in subsidiary ledgers. Formerly, the warehouse and shipping expenses were treated separately from selling. I feel that these should be combined and considered as one, representing as they do the penalty for failure to dispose goods promptly on terms carrying shipping charges. Viewed in this way, they become a charge against the selling organization in the same manner as commissions and are consequently joined for the primary analysis.

In designing the procedure to carry out the general accounting, two thoughts have been kept in mind: the minimum information needed for effective recording and control and the means whereby this can be achieved with least effort. To carry out the latter policy, one-write systems and time-saving devices have been used wherever possible. Commercial systems have been used in some cases and, in others, forms have been designed and procedures installed according to the circumstances.

The daily records of the cost department reflect the movement of raw and in-process inventory according to the reports received through work tickets from the various departments. The summary of these daily work sheets is entered in the journal and forms the basis of the monthly cost ledger entries. The production reports, received daily, are also used to provide the daily labor report which records daily labor hours on a paid and earned basis. This report, completed daily and forwarded weekly with comments to management, provides a prompt and efficient check on the operation of the plant.

The general procedure is designed to work closely with the requirements of purchasing, stores and cost departments. The incoming invoices are processed as quickly as possible after the controls of quality, quantity, price and extension are checked. Prompt entry and closing-off at the end of the period assist materially in the speedy preparation of statements.

THE STANDARD UNIT COST

Formation of the standard cost of the unit commences with the drawing. The complete drawing of the article, usually showing perspective, is followed by full-sized detail drawings of each part. These are grouped, of course, on one drawing when possible or when it is desirable to show their relationship and the detail of joints, position of fastenings, and other special details.

The material requirements are entered on the stock bill and details of wood, dimensions and instructions noted. The stock bills for the lumber are supplemented by the hardware requisition. In this case, the supplier and catalogue numbers will be known from the designer's specifications and will be noted. The material computed is the net figure required which, with the addition of waste allowance, becomes the material section of the standard cost card. It is customary to list all raw material, including finishing material, on the card but to treat screws, etc. as a variable overhead item along with glue, abrasives, oils and rubbing compound. The finishing materials are computed on the surface area to be covered and the type of finish specified, which will indicate the number of coats necessary.

A similar detailed approach is necessary for standard labor. Just as each drawing gives rise to certain material requirements, it also proclaims the operations necessary to fabricate the material from the rough state to the required dimensions. The sequence of operations is listed for each piece and the time for each operation calculated and extended on the specification and routing sheet. Each machine and handling operation in the furniture industry has been under intensive time study for a number of years. Consequently, complete engineering reports are available for each operation showing the time required for every width, thickness and type of wood generally encountered. Set-up times and other similar factors and allowances are also included.

From this data, the standard labor time is gradually evolved. In computing the standard, the size of the run is a primary factor. An attempt is made to provide enough allowance to permit a 20% gain on standards with utmost effort. This will provide for payment of an incentive bonus. The final summary of labor cost is entered on the labor estimate sheet and, in turn, carried to the standard cost card.

The application of variable overhead rate completes the computation of standard unit cost. The cards are filed by suite number and form the basis of recording operations.

The engineering department, responsible for the data incorporated on the card, is constantly checking the practical application of the information by time study methods, and working out and applying modifying percentages when local conditions make a normal standard impossible. In addition, they are constantly devising more uniform and economical methods of fabricating the material to reduce cost and produce more rapid and accurate costing. In many cases, rapidity in establishing the cost and quoting the price is a governing factor in obtaining the order. The importance of a keen, swift, accurate and progressive engineering department cannot, therefore, be over-emphasized.

The information obtained from the standard unit cost is, of course, used throughout the ensuing operations of planning and production. The significant products of the cost obtained are:

(1) Desired selling price
(2) Contribution to fixed charges and profit
(3) Material required
(4) Labor hours required

The first two factors form the basis of policy formation and sales mix planning. From them, the results of the operation can be anticipated. The last two give information for estimating the percentage of plant capacity used and material needed for the production planned. Thus all forward planning or the results of any change in plan can be drawn up with confidence and the needed action taken.

MATERIAL

Raw material is under the direct control of the purchasing department which not only negotiates the acquisition of new material but receives reports from stores and inventory control. The main function of the department is, of course, to purchase advantageously and to ensure that material is available in the quantity and quality needed. Equally important is its secondary function, a natural development of the first, which is to maintain inventories at a constant level sufficient to assure the continuance of operations. This factor is controlled by reports to the purchasing department from inventory control, a branch of the cost department.

The purchasing department is activated by the receipt of requisitions for material. These may come from the various section foremen requiring factory supplies or from the engineering department representing the requirements of a certain cutting to be undertaken.

The primary planning preceding the establishment of the standard cost provides the information necessary for these requisitions. In each case, careful attention must be given to existing inventory and the requisition is only made after a careful review of the conditions shown by stock control reports. In all cases, these important requisitions are reviewed by the superintendent before submission to purchasing.

Quality control is maintained through the engineering department. Invoices, before being passed for entry and payment, must have attached the copy of the order form, the shipping copy and receiving slip. In addition, the stamp on each invoice must bear initials to show that extensions, footings, price and quality are in order. The document is routed to engineering for quality approval, purchasing for price, cost for account classification and standard cost, and then to accounting for entry and payment. Close co-operation between engineering and receiving ensures that tests are made promptly on receipt so that claims or rejections may be made at once.

Inventory control is maintained by reports on a monthly basis but stock records are available for checking purposes at any time. Provision is made for checking actual inventory with book records on a periodic basis and for adjusting any discrepancies found. A weekly report of outstanding orders is forwarded to the purchasing department to aid in checking delivery delays.

The price variance is an automatic by-product of the purchase journal. The segregation of the cards provides the standard and actual totals of the month's purchase operations and the entry from this information in the journal provides the variance. A monthly report giving the detail under the major headings provides an analysis of the variance on a monthly and cumulative basis.

The usage variance is obtained from an analysis of raw material requisitions against the standard material usage. The synopsis of total usage, under the established headings, against the standard usage is shown on the appropriate report. This report is extremely important in studying the adequacy of established waste factors.

Waste factors are percentages obtained from years of engineering study and experience. Their application in the computation of standard unit material cost is a fundamental part of material cost computation. The study of usage variances is the most obvious means of testing their adequacy. Consequently, each usage variance is checked against material quality and shop performance if a decision must be made concerning the adjustment of the waste factor.

Raw material and its control remains one of the important aspects of efficient operation. Proper check on price, quality and inventory level presents only half of the picture. Equally important is prompt control of waste and maintenance of a tight control of usage within the limits set by the standards in operation.

DIRECT LABOR

It is common in large furniture plants to develop piece work rates and pay on that basis. In the smaller plant, however, the custom has not been widely accepted because of the time and personnel required for inspection and the clerical effort. The pay is, therefore, governed by the individual time card.

Variances are finalized monthly on completion of the labor analysis sheet, which takes into consideration the movement of labor to various sections as reported on the time sheets, and other deductions from direct labor, such as paid statutory holidays, etc. The final results of the analysis give the hours and amount of labor for each department during the month, together with indirect labor segregated by account. Against this, the labor content of the production, recorded from production tickets, is entered daily and accumulated on a monthly basis. The rate variance, being the difference between actual hours at actual pay and actual hours at standard pay, is found together with the efficiency labor variance of standard hours at standard pay against actual hours at standard pay.

The record of the daily production, in terms of direct labor hours, provides the basis for the daily measurement of plant efficiency. Indicating as it does the departmental efficiency variance, it is possibly the most important report in keeping management informed of current plant activity.

A further refinement of the daily calculation of standard labor produced is the employee bonus sheet. This records the value of end production in standard hours at actual rates. Against this are compared the actual direct labor hours in the day at actual rates. These are obtained by computing the direct hours of the individual direct workers at their respective rates. The net result, gain or loss in direct labor hours at actual rate, is credited or charged to the bonus payable and posted daily on the bulletin board. At the end of the month, the bonus appearing is distributed among the workers on the basis of earnings and paid in the first pay following the completion of calculation.

The end production is used to ensure correct fabrication of all material throughout all processes so that no rejection of material or delays are possible without interfering with the bonus. In this way, each worker, from first to last, is interested in turning out perfect work. He is also interested in keeping the number in his group

to a minimum to ensure lower direct wages in relation to production and consequently, higher bonuses.

The standard labor is computed to occupy the full capacity of 80% of the perfect capacity per time study. In theory then, employees by a full, sustained effort should be able to make a bonus of 20%.

MANUFACTURING EXPENSES

The division of manufacturing expenses, which comprise the factory ledger, into correctly named and suitably designed accounts, presents the necessity of a compromise. It is desirable to point out strongly expenses in relation to production while, at the same time, limiting the number of accounts in order to save work on petty details and lend, if possible, more emphasis to controllable expenses and divisions of expenses. It adds little to expense control to have insurance, for instance, divided into many separate accounts when the main emphasis should be that the total insurance was a fixed charge of a certain amount. For this reason, accounts should be presented as a division total, leaving analysis, where necessary for accounting control, as a subsidiary presentation.

The analysis between fixed and variable expenses assumes possibly greater importance under the direct cost method. Having in mind the emphasis considered desirable on the fixed charges and the productive sales activity that must surround them, I am inclined to lean towards the allocation of a border-line case to the fixed expense portion. Some costs will vary slightly with production, but if the organization is to be held together and function in a manner similar to its original concept, then these costs are factors to be overcome by sales and, as such, belong in direct cost.

Departmental analysis of factory overhead does not assume quite the importance given it under the usual standard cost methods. It is true that the efficiency of the department must be measured but, the large portion of the costs being eliminated from the discussion, there remains only the problem of ascertaining that the applied burden is covering the actual departmental share. Segregated as the costs are, under direct costing, the control is simplified greatly. In the machine room and veneer section, only the basic supplies of glue, tape, etc. are of any great importance and, similarly, in the cabinet and finishing rooms, the amounts and consequences of control are appreciably lessened.

The departmental analysis is, however, particularly desirable in substantiating the variable burden rate stated on the standard cost card. This rate is important in the correct valuation of in-process inventory in all stages of construction. It is particularly important when sudden changes in production, resulting from a shift in sales, cause storage of sections of the inventory in the unassembled, assembled but unfinished, or in the finished but pre-rubbed state.

The distinct advantage of the direct cost system under these conditions is readily seen. It is no longer desirable to hold such items at a material-only value on the premise that they should not bear the cost until assembled into a potentially saleable product. Even occasional application of this method could result in chaos and utter lack of control. Proper cost control demands the instant valuation of in-process inventory at the correct standard value. Under direct costing this is the normal procedure and the result of the change in policy is reflected in the proper place—

the contribution of sales to fixed charges.

The allocation of service charges under direct costing becomes minor, even negligible. Most services are fixed in their nature. The building, taxes, insurance, light, heat, power, engineer's services, watchmen, maintenance, etc. can all be regarded in this category. As long as the plant is alive and operating, these charges will be present. It matters little if the small plant, in particular, is operating at full or partial capacity. In the main, these items will still be present in the same amount. For practical purposes then, services can be regarded as a direct cost forming a portion of the general burden taken by sales.

The general accounting methods charge the factory ledger and its controlling account with items allocated as a manufacturing expense. Prior analysis will have established the direct charges applicable in each account. The monthly segregation of the variable portion for statement purposes is carried out by the application of the fixed portion to the total monthly charge and the extension of the remainder.

The variable burden rate, set up on the basis of past performance analysis, is judged very carefully as the actual performance unfolds. It should be reasonably sustained throughout the entire scope of operations, but much useful information may be obtained by charting it carefully at different levels and ascertaining the desirable rate to apply that will ensure complete coverage of actual expenses incurred of a variable nature. Under normal circumstances, the variable burden rate originally chosen will prove sufficient for the operation. The variances between actual and standard production hours have been found to provide more significant control. If these are indicative of constantly favorable results, the burden variance will likewise be in order.

By far the most significant division of the cost analysis is the fixed burden. Segregated as it is from the other operation costs, it becomes the focal point of the entire operation. In the final analysis, it becomes the responsibility of sales. It is their challenge to accomplish the passage of sufficient merchandise to overcome this and similar charges. The means of accomplishing this enforce the keenest analysis and closest co-operation between the production and selling forces.

The fixed burden is stated separately from the manufacturing section of the profit and loss statement along with other charges such as selling, administrative, etc. This type of presentation affords a rapid and economical assembly of data. Once the fixed burden is established by a process of analysis of separate accounts, only the total need be presented in future statements. The auxiliary schedules of variable expenses may, however, be presented in detail should the variance indicate a more detailed study.

Direct cost has been attacked on many grounds, chiefly that the current manufacturing expenses are a part of current production. While this may be so, the important point for management to realize is that these expenses are overcome by sales and, in most cases, will be present as long as the plant is organized for production, whether producing at a normal or sub-normal rate. This being the case, it would seem that a divorce from production could be helpful in throwing the presentation into proper focus and placing the accent on the correct portion.

PRODUCTION

The basic problem of production is, of course, keeping sales supplied with a

product in the quantity and quality desired. The secondary problem is to maintain a production level that will absorb the direct labor employed to carry out the anticipated production, as set forth in the budget.

The prime results of the deliberations of the budget committee are to establish anticipated sales and the required cutting orders to cover these sales. The resulting extension of the direct labor hours gives the normal labor hour capacity of the plant. Provided this is constantly maintained, it may be conceded that the production operation is successful. In many cases, even in the face of lagging sales, it is desirable to sustain a steady production for the purpose of having inventory ready for prompt action when the market re-opens, and also to retain a state of high efficiency in the organization. From the start of production, it should be quite clear how many labor hours can be devoted to marginal operations and during what periods this type of operation is desirable. The sales activities should be directed towards completion of the plant's production in the slack periods by emphasis on this type of work.

The development of the original budget along production lines will give a clear picture of the manufacturing level necessary to meet the existing charges of labor and the variable overhead rate as set out in the preliminary examination. A continual problem is posed by the inter-flow between the different divisions of the organization and the necessity to store inventory pieces in a manner that will not interfere with the efficiency of normal production. If the standards are constantly met as evidenced by the daily examination of direct labor and if the quality of the product satisfies the demands of sales, the problems of production are considerably lessened.

The movement of material throughout the plant is reported by a series of cards. The first division, the machine room, presents the inventory as unassembled pieces and processes them through various operations until the required fabrication is completed.

A material bill ticket is then attached to the load and remains with it throughout the ensuing operations, the break-out portion having been torn off and forwarded to the office. Control of the break-out movement of raw material into process is obtained from the collection of break-out tickets on a daily basis and forms the first entry recording the movement of raw to in-process inventory.

On admission to the cabinet room, the raw material for this department is still identified with the material bill and remains in storage until the assembly process. The process of assembly is an all-embracing term, taking in the operation of the case clamp. Prior to assembly in the case clamp, drawers and other articles are sub-assembled and all fed into the area immediately after the case clamp. As the article is now assembled and identifiable, the blue ticket, stamped with the suite number and description, is attached and remains with the item through the cabinet room, where drawers are fitted, doors hung, etc. Following this operation, the goods-in-white portion of the ticket is detached and forwarded to the office, showing that the cabinet room operation may now be added to the in-process charge.

Inventory storage in white is desirable as the manufacturer still has the opportunity of selecting the color demanded by the inflowing orders, while at the same time the article may be stored with less possibility of damage than in the finished

state. It is desirable, however, to put batches through in various colours and to store sufficient inventory in the pre-rubbed state to meet all normal demands. In this stage, the basic colors and filler have been completed along with lacquer coats, but no hand rubbing has been done nor has the hardware been added. Upon receipt of the pre-rubbed portion of the ticket, indicating that this operation has been completed, the standard cost of the finishing room and its overhead may be added to the represented in-process inventory.

Under normal conditions, the inventory remains in this condition until the sales order has been received. Little time is required to complete the article from the pre-rubbed stage and it can be shipped within a day or two from receipt of the order.

Office procedure forwards a production order and, from this, the selected pieces from the pre-rubbed production, still with their remaining portion of the ticket attached, are passed through the rubbing room, the hardware added and the packing done. On completion of these operations, the finished production section of the ticket is forwarded to the office, indicating that the rubbing room costs and the hardware may be added and completing the standard cost of the article and its transfer to finished goods inventory. The ordinary operation of the invoice removes the goods from finished goods inventory to cost of sales. Thus, through the collection of ticket stubs, entries can be made to report the value and movement of inventory from the raw material to the finished state.

The control of labor follows the pattern outlined previously for direct labor. The labor content of the daily production is reported and forms the basis of the analysis of plant operation. Because of the procedure in setting standards, it should always be possible to gain on the standard cost. From the production cards received daily at the office, the standard labor content of the production is recorded on a departmental basis. If an excess of paid labor appears, indicating a deficiency in production, the matter is reviewed daily with the foreman or superintendent and corrective measures are taken. If this is not possible, owing to abnormal circumstances, a remark is made to that effect along with indications when the difficulty will be overcome and the matter is reviewed weekly by management. It is thus found that co-operation between the various factors is maintained and production proceeds under complete control at all times.

The labor report is the main guide to all regulation of plant activity but, should unfavorable reports be made, supplementary statements of production are available if desired.

As mentioned previously when dealing with the incentive bonus, the general plan of paying the workers for any gain that they make creates keen interest in finding short cuts and results in very close co-operation between groups to foster increased production. In practice, it is found that very little intermediary supervision is needed, since the natural skill and experience of the workers lead them rapidly into the "one right way" of performing an operation. The application of an occasional time study will overcome any unanticipated difficulty, while repetition of a new operation will usually nullify all but major difficulties and bring actual and standard production into line.

GROSS PROFIT

The selection of the product and the price at which it can be sold is essentially

the problem of the sales department. This is of such importance that, in most cases, it automatically establishes the success or failure of the operation. Much will depend upon public appeal, current thinking of the prospective customers, and trends in style and home decoration. The sales department must decide whether a relatively slow-moving but staple article in a certain price field is to be preferred to a rapidly moving but relatively short-lived article in another field. In this regard, the amount of inventory to be carried to fill current requirements should be considered and is often a stumbling block when selecting a certain type of furniture.

A further product group which is essentially apart from the main furniture manufacturing is that provided by the television and high fidelity industry. The supplying of cabinets for this industry has become, in many cases, a major portion of the output of a furniture manufacturing plant. The high competition in this field, however, has made it attractive only as a marginal item. On occasion, profitable use may be made of the plant facilities for this purpose, but only if there will be no interference with the production of furniture.

Each of the divisions contributes in a different amount to the direct costs. It follows that, in lining up the production and sales activity for a year, the market should be carefully analyzed and the results of the activity of various components of the sales picture should be considered along with the contribution towards the fixed cost and profit. Decisions in this matter are often very difficult and involve predictions concerning the probable increase of sales if certain price concessions are made. The advantage of direct costing is, of course, immediately apparent, as the break-even point can be readily obtained on any type of product or any combination of product mix.

The union of sales with production is always kept in mind when considering the gross profit obtainable from different sales mix. Plant capacity limits the entire picture but in most cases, it is equal to or above the best efforts of the sales department. It follows then that the main planning should be towards a steady production level at the expense of direct cost contribution, provided that sales are supplied with their needs as they are felt.

The entire consideration of gross profit is closely linked with budgeting and results in the general budget for the year. Modifications of this, as the actual sales needs are felt, give rise to further considerations of sales results and the adjustment of production necessary to achieve the plans. It is possible to predict the results of these changes quite readily, in terms of gross profit, by the application of the standard cost and to consider further and revise the results of operations with a view to increasing gross profit as the results of plans become evident. The final outcome, incorporated in the budget, is subjected to comparative methods as the actual activity progresses.

The study of the gross profit resulting from operations forms the focal point of all planning and comparison of the desired result with the actual provides information essential to revisions of the original plan for maximum results.

CONTROL OF EXPENSES

The direct control of expenses is accomplished only by the strict provision in the budget on the basis of past experience and strict adherence to the budget as laid out. A goodly portion of shipping, selling and administrative expenses falls under

the fixed expense category and, consequently, sales in the lower brackets will indicate a higher percentage. Shipping charges will, of course, vary with the amount shipped except that shipping wages will be largely fixed. It is possible therefore, in this category, to segregate the portion and, on the flexible budget, to allocate the ratio between fixed and variable expenses on the anticipated sales. Within slight limits, the shipping expenses should hold a definite ratio to sales and this can be included in the computation of anticipated profit.

The control of selling expenses depends largely on the type of selling organization established. Where most of the selling is done by representatives on a commission basis, the control is rather remote and selling expenses are strictly variable. When, however, direct representatives of the company are engaged in selling, the control is strengthened in the cancellation of variable charges and the institution of fixed expenses. It is possible however, by careful budgeting, to establish a ratio of sales which governs the expenses. At the beginning of the year, the amount allocated to advertising or other business promotion will be established and incorporated as an expense to be dealt with in computing the percentage factor in relation to expected sales. In general, it should be possible to establish the ratio of selling expenses to sales and, by this means, control the actual expenditures to the amount allocated by the budget at the beginning of the period.

Of the various expenses under study, administrative expenses contain the greatest amount of fixed charges. It is therefore possible to predict the general result of increased sales or a general result of the expenses in relation to sales at different levels. Certain items of administrative cost, such as stationery, will of course vary with sales activity and may be predicted on a variable budget method. The control of expenses can be carried to an extreme degree but, in general, a close adherence to budget should be sufficient to maintain effective control and to carry out the efficient operation of the concern with minor extravagances.

THE BUDGET

The establishment of an effective budget is a problem calling for the exhaustive analysis of past performance, the prediction of future sales trends, and the co-ordination of the anticipated results of activity surrounding the two concepts. The budget automatically divides itself into the categories under study; namely sales, production, and the extraneous services necessary to organize and report on the results of activity.

The sales budget must consider the various types of product and their contribution to fixed expenses and profits. This approach draws information directly from standard costs and, if these have been satisfactorily established and rigidly maintained, it is possible to establish the break-even point for each type of product or the desirable product mix, together with break-even analysis. In a similar manner, sales and the related standard cost will give a profit-volume relationship of any product mix. This, and the break-even analysis, can be graphically portrayed on a budgeted basis and, later, comparatively with monthly actual performance of the concern. As the selection of product and product mix is the essential operation that directly spells profit or lack of product, it follows that too much attention cannot be paid to the results of various price changes and anticipated volume along these lines. It is desirable, when reporting on this section of the work, to use graphic

analysis if possible to capture the attention and dramatize the results of decisions.

The production section of the budget is assimilated from the existing standard cost. In this section, the use of labor should be particularly noted, as well as inventory requirements and the length of time the inventory will remain in storage. Some types of inventory do not lend themselves to rapid transition and this, of course, has a direct bearing on the funds required to carry out the entire plan.

In establishing the manufactured cost, strict emphasis must be placed on the fixed costs which, under this plan, become direct costs. The existing fixed costs and any anticipated changes in these must be studied carefully. These changes must be incorporated in the event production is expected to exceed the present normal capacity of the plant. Extreme caution should be exercised in calculating the variable manufacturing expenses, as the variable overhead rate is based upon these results.

In establishing the contribution of each article, it is well to analyze and project on a budgetary basis, the selling, shipping and administrative costs. The percentage factor in each case will vary with the different levels of sales and careful projections at various anticipated levels will ensure proper control and accurate forecast of the net profit.

Brevity and simplicity should be the keynotes of the comparative reports, both as a means of eliminating extraneous and confusing matter and saving on clerical labor.

The suggested monthly reports and their recipients are listed below:

OFFICIAL	REPORT
General Manager	Balance sheet
	Profit and loss statement
	Inventory detail
Sales Manager	Sales detail
	Expenses—selling
	Inventory detail
Superintendent	Manufacturing expenses
	Variance report—lumber usage
	Variance report—other usage
	Variance report—labor price
	Variance report—labor efficiency
Purchases	Inventory detail
	Variance report—purchase price

The statement to the general manager provides a summary of operations which is clear of detail. The subsequent statements enlarge on this. The statement of manufacturing expenses gives the detail of the applied manufacturing expenses at standard rate X standard production hours against actual expenses and furnishes the first example by which the actual performance may be checked.

The reports to the various subdivisions emphasize the detail required to control their sections. This, supplemented by weekly progress reports on the use of labor, provides sufficient information for efficient control.

CONCLUSION

The main aim of the foregoing has been to present a simple, efficient, and readily effective plan of cost control that will provide management, at least clerical effort, with the main information needed to plan and correct any deviation from plan in

a small furniture industry.

Though greater detail is available for control purposes, the system presented here should convey to an intelligent management the results of existing conditions and the means by which any adverse results can be corrected. Economy of clerical work is a feature of the system, which has also been planned to ensure the prompt assembly and forwarding of reports to management.

The emphasis on direct costing makes readily available that most potent feature of modern operations, the contribution to fixed charges and profit. The ease by which the break-even and profit-volume relationship of any type of product mix may be obtained is a desirable and essential feature of this type of cost control.

There is ample provision in the analysis of overhead to prevent unwarranted waste and ensure adherence to the budget. At the same time, exhaustive analysis has not been attempted, as the primary indication of deviation from a desired line is shown. This should be sufficient notice for the production team of a small plant to regain and retain complete control.

The provision for storing inventory at various stages of completion with the least possible accumulation of charges is a very desirable feature. There is no danger of overvaluation of inventory, but at the same time each section of production receives prompt credit for inventory processed.

The most illuminating feature is the segregation and presentation of fixed charges. This often escapes the attention of even experienced accountants and it is a constant source of surprise and annoyance to management to realize the extent of fixed costs and the extent of effort that must be made to overcome these before a profit is possible.

The control of industry by direct cost methods, therefore, is a direct contribution in this regard and will no doubt have a very desirable effect upon the forward planning and considerations of the management team. The endless task of the accountant in explaining the differences between anticipated profit in relation to sales and actual profit when the combination of sales and production is realized under normal accounting procedure, is eliminated. It is possible to approach management at all times on the basis of sales and their contributions toward direct costs. This simplifies and emphasizes the main problem of every manufacturing concern, the creation of substantial profits.

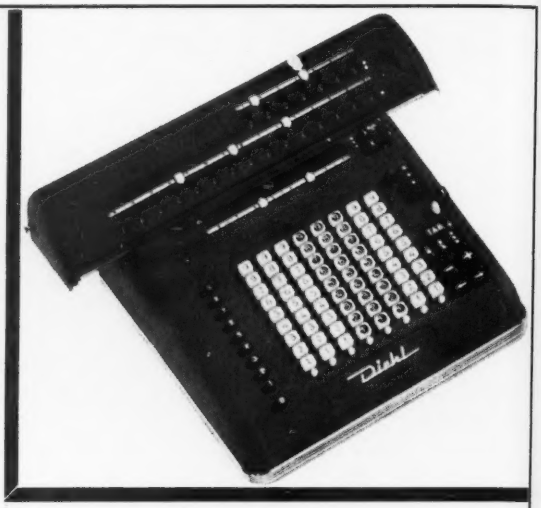
It emphasizes, too, the necessity for careful planning when expansion projects are contemplated. It is possible in these cases to state definitely that the resulting direct costs will substantially increase and sales must be prepared to undertake the additional charge. Too often this matter is lost in the discussion which precedes plans for expansion.

The emphasis on the break-even point and the profit-volume relationship stands as a constant warning to management of the margin by which existing sales exceed the break-even point. The important feature of marginal costing is clearly presented and is ready at any time to provide the information required to support a decision on this matter.

It is felt that a corporation having need of cost system which is economical and adaptable to a flexible production and sales economy would greatly benefit from the examination and study of direct cost methods.

Right

ACROSS CANADA



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TOPICAL

comments *by N. R. Barfoot*

LOOKING AHEAD

The new cars are all on view and the big three plus the independents are looking for a 6.8 million car year in 1960 in the U.S. If attained, this would be an exceptional total, only reached before in 1950 and 1955. The forecast is based on a strong economy and high consumer disposable income. A full range of cars from the new compacts to luxurious highway pullmans is offered along with newness, some economy alternatives in engines, and less ostentation, which is unusual.

An American executive makes a practice of writing his top and middle executives each year asking whom they would nominate as successor in case of his demise. This has proved successful in (a) recognizing the logical successor and (b) uncovering a situation where no successor existed. Have you ever tried this?

Oil in the Arctic drew most of the major oil companies into extensive geology work this year.

Eighty million acres were taken up this year in the Arctic islands.

The perma frost is 2,000 feet deep but, in summer the top few feet are a spongy mass which makes drilling impossible unless the ground is re-frozen. Transportation by suitable wide-track vehicles over this type of ground is extremely tricky in the summer and makes costs very high.

Big problem is how to reach markets when oil and gas are found. Most likely bet would be pipelines to the Pacific or Arctic coasts where off-shore shipments could be made.

ON THE PERSONAL SIDE

Pointers on how to be a complete failure:

- Stay within the accepted pattern. Always follow the lead of your confreres, even if they are heading for oblivion.
- Leap before you look. Your first thought is always the best.
- Decision-making is now a science; get a computer and relax.
- Smother the organization in red tape. They won't get much done but they won't make any errors.
- Keep subordinates in their place. Hold them in tight compartments and their ideas, if any, will die for lack of air.
- Have everything cleared through you. Then you can make sure it is done right, that is, the way you would have done it.

Professional interior design and decorating of private offices is becoming quite the thing. This usually reflects either personal activities—nautical, sports, hunting, travel—or individual tastes in furnishings.
The professional decorator is usually hired by the hour and the purchasing done through the corporation. If moving into a new office, such expert advice should be had in advance so that the arrangements with the owner may be made concerning requirements for floor coverings, outlets, partitions and fixtures.

New gadgets include magnetic playing cards that will not blow off the table; plastic egg openers that neatly lift the top from a boiled egg with a turn; electric light bulbs that diffuse light so that lamp shades are unnecessary.

Ideas come fastest if you follow these routines:
Attack part of the problem—try related thinking—pick a worry-free time—remember the limits of your thinking processes—don't try it alone all the time—try for idea sessions after the day's detail is done—don't try it after eating—ideas are best when you are hungry. Doodle your way into ideas—do some reading on the general problem—learn to shut out everything else except the problem—learn to use your subconscious.

OF GENERAL INTEREST
Transportation Revolution
Piggyback or the highway trailer on a railway flat car represents one of the most dynamic changes ever in Canadian transportation economies.
There are five plans:

1. Independent truckers' trailers riding on flat cars
2. Railway-owned trailers on flat cars
3. Shipper owns the trailer
4. Shipper-owned trailers and flat cars—railway merely does hauling
5. Joint truck-rail rates, permitting each to take shipments originating in or going to each other's territory.

- Canada has the first two plans and is going into number three
- Savings of 40% may be possible
- Line haul costs of piggyback are one-third of highway haul
- More flexibility is possible, i.e. rail sidings to plants not necessary
- Mixed passenger freight service possible again
- The C.N.R. has 700 piggyback flat cars in service and the C.P.R. has 850
- In 1960, C.P.R. will carry 100,000 trailers and the C.N.R. approximately the same
- Traffic executives are very optimistic over this new venture. Any number of variations is possible which will provide cheaper rates.

Second mortgages are available from a new source and in a new way. A prominent oil company interested in retaining its market for home oil users offers a second mortgage on new houses if an oil burning furnace is installed.
The mortgage bears the same interest rate as the first, but not less than 6%.
It is not earmarked as such but is roughly constituted to match the cost of the heating plant, namely up to $1,200.
The plan is offered in the Maritimes, Quebec and Eastern and Western Ontario where fuel costs between gas and oil are comparable or in favour of oil.

THE FINANCIAL EXECUTIVE'S ROLE IN PLANNING AND ORGANIZING FOREIGN OPERATIONS

By Charles Moller,
Management Consultant,
New York, N.Y.

Branching into foreign operations is a step which can be profitable but requires careful scrutiny. Among the aspects which must be considered are marketing and monetary restrictions, methods of operation, taxation and personnel problems in the foreign country. In this article, the author outlines the major considerations entering into foreign expansion.

DYNAMIC management will seek consistently to expand operations wherever and whenever such expansion can be reasonably expected to earn adequate profits for the enterprise and does not involve undue or disproportionate risks.

This article will concentrate on questions connected with *expansion of activities into foreign countries.* Obviously, a decision to branch out into countries outside Canada will involve top management in considerations other than the usual ones of "Which line?", "Which items?" and "Which group of customers?" Also involved here are problems of foreign investments, foreign financing, foreign taxation, foreign psychology and foreign personnel.

Some organizations have made the decision to branch out abroad and they have been justified, for the most part, by very profitable and by no means negligible foreign operations. In the United States the trend is still in the direction of foreign expansion, and even medium-sized and smaller corporations have been well advised to investigate their opportunities in that direction. In Canada, however, foreign expansion is in its first stages. The export and foreign trade statistics speak a clear language and make interesting and provocative reading for any executive who still doubts the value and reasonableness of branching out of the domestic markets.

An important stimulus for Canadian executives, of course, is provided by the increasing impact of the European Common Market. Even as envisaged at present, this will present an overall consuming population at least equal to that of the United States. To overlook or disregard this favorable trend in Europe and the population growths in South America and elsewhere would seem unwise. The decision itself, after proper investigation, may still be in the negative; but at least top management can show that all possibilities were probed and ventilated and the pros and cons weighed before the negative decision was made.

Born in Prague, Charles Moller studied Law and Political Science there and Commerce in Vienna. He had banking, insurance and legal experience when he came to the United States after a short stay in England in 1940. After varied experience, particularly in the watch-making industry, he undertook a two-year management consulting assignment in Switzerland. He has been engaged in consulting work in New York for several years.

Once the basic decision to go into foreign markets is made, the question arises of which particular country to select as a starting point. This decision is of utmost importance to the success of the whole scheme, for experiences met in the initial country will greatly, if not completely, influence all further decisions on foreign operations.

This is the point at which the *financial executive* comes into the picture. The analyses which top management must have to arrive at reasonably sound decisions are numerous and often involved and extensive.

MARKETING AND MONETARY STUDIES ESSENTIAL

Foreign markets will have to be studied and restudied from a *merchandising and marketing* viewpoint. These studies may be made scientifically and systematically, or superficially by random sampling—depending on the size and organization of the corporation and the degree of commercial development in the country investigated. In any case, "marketing" research should be understood in the broadest sense of the term, i.e., it will not be restricted to problems of selling, quantities and qualities, but will be concerned with such questions as sales promotion, advertising needs, psychological reactions of the population, etc.

Only if the results of the merchandising and marketing studies are positive and encouraging will it be necessary for the financial executive to continue with the other, equally important investigations:

Foreign competition and the internal power and influence of foreign competitors must be carefully evaluated. This is the area where political trends in the foreign country and political animosities and influences will play their important part.

This point leads into the next problem on the financial executive's task-list, namely the problems of *foreign restrictions, both monetary and market-wise.* Economic and monetary dislocations in the foreign country will present a continual and weighty headache to the export manager or financial executive. Though it is not humanly possible to foresee all the eventualities of the future, it does seem essential to acquaint oneself with the present situation in a foreign country, to study and evaluate past developments and experiences and, within human limitations, to project the results into the future.

Market restrictions hamper business and increase cost of operations. They can be overcome in many instances by setting up independent or partially dependent subsidiaries in the foreign country as we shall see later on

Monetary restrictions hamper the flow of funds and may even make foreign operations useless and nonsensical. They may be overcome either by setting up supplying outfits in countries other than Canada with which there may be no or fewer monetary restrictions, or by going into the complicated field of compensatory transactions. Briefly, this latter means to avoid outright remittance of monetary funds by compensating one export business transaction against another import transaction even to the extent of involving one or more unrelated countries.

This is a highly specialized and intricate procedure however, and unless reliable facilities exist within the parent corporation *and* the foreign set-ups to cope with the situation adequately, the financial executive is probably better advised to avoid countries with stringent monetary restrictions.

METHODS OF OPERATION

Depending on the results of the marketing and monetary studies, the financial executive must then devote his attention to the problem of the most suitable *methods of operation* for the country under scrutiny. In determining these, he will have to consider not only the situation in the country under study but also similar situations in other countries in which expansion is planned subsequently.

Among the many varieties of set-ups, there seem to be these basic possibilities:

1. Export through foreign distributors.
2. A foreign division within the organization of and handling all foreign trade through the parent company.
3. A foreign division within the foreign country which handles all foreign trade but is and remains part of the domestic parent company.
4. An independent subsidiary in the foreign country.
5. A headquarters subsidiary in one foreign country which handles all foreign trade within that country and with all other foreign countries.

Important and far-reaching motivations will influence the financial executive's decision on what kind of foreign operation should be advocated in a given case.

Export through foreign distributors is usually the most direct approach to the problem. However, considerable importance should be attached to questions of monetary restrictions as outlined above, and also to those of *taxation.*

Profits from direct exports from Canada to a foreign country are fully taxable under the Income Tax Act. Profits earned by a branch, (not a wholly-owned or controlled subsidiary of a Canadian corporation) in a foreign country are also fully taxable under the Income Tax Act, yet any income tax paid by that branch to the foreign country may be claimed as a tax credit againsts the tax levied in Canada within the limitations prescribed by the Act. Finally, profits earned by a subsidiary of a Canadian corporation, either wholly-owned or controlled, resident in a foreign country do not come under the Income Tax Act as long as such profits are not transferred to Canada.

From this brief outline of tax considerations, it can readily be seen how important such calculations and evaluations will prove to be once operations have begun to show profits on a larger scale. In some foreign countries the corporate income tax rate is considerably lower than that now applicable in Canada; in others it is higher.

OTHER IMPORTANT CONSIDERATIONS

There are still other aspects which must influence the decision to expand into a foreign country. For instance, how will the *personnel problem* be handled? Can Canadian methods and attitudes be transplanted grosso modo into the subsidiary or will Canadian principles have to be modified by foreign thinking and requirements and to what extent? Should one operate as a "Canadian" outfit or as a "domestic" organization in the foreign country? What are the labor and white-collar relationships in the foreign country and how do wages and salaries compare with Canadian standards? What inter-governmental agreements exist?

Questions of *double-taxation* treaties play an ever-increasing role in this connection and it will behoove the financial executive to pay close and constant attention to them in his survey.

How much of a *remote control system* must be imposed upon the foreign sub-

sidiary and how can it be done to avoid friction? How can confusion and conflicts be avoided in such a relationship? These are among the many and varied problems which the financial executive will have to solve if he is to discharge his responsibility properly and each could form the subject of a separate treatise.

In order to evaluate the *psychological aspects* of the situation, the financial executive must have at least some knowledge of the country in question or he must have information from those who are familiar with its population and framework. In evaluating the tax and other legal provisions of a foreign country, which are often quite different and intricate, he must rely heavily upon information and advice from experts in the field in that particular country.

Apart from legal provision, government actions which are not directly foreseeable from the existing legal status must be anticipated in many countries. Some countries hinder exports, some subsidize them; some hinder imports, some support them. Moreover, a given situation may change without notice.

Obviously, no single executive will ever have the knowledge or the time to explore personally all the varied and specific aspects which determine the overall pattern of an operation; he will have to rely upon and evaluate the propositions and opinions submitted to him by experts and division heads.

However, in the initial stages of evaluating and planning, the financial executive won't have any division heads at his disposal in the foreign country. During this period, it may seem advisable to entrust the whole research program to outside people who, with their experience and connections, are usually well equipped to unearth the correct answers to the many problems in their widely-varying fields.

BE GUIDED BY BUDGETARY FIGURES

The financial executive will be in his own domain when it comes to questions of *profit, rentability and budgets* for the new foreign enterprise. During the planning stage nothing more than estimates will be at his disposal, and nothing more than budgets can be expected. However, it is most important to be guided by budgetary figures right from the start of planning since only then will top management be in a position to determine whether there is a good chance of succeeding and earning a reasonable profit.

The yardsticks for measuring management and comparative divisional performances will in most cases be determined by the general yardsticks used by the parent corporation. The normal yardstick is still profit as expressed in percentage points of sales. It is obvious, however, that such a yardstick will not present the best possible means of evaluating future possibilities in a still non-existent foreign enterprise.

In such a case, a better principle to rely upon would be *"return on invested or disposable capital."* Usually, the financial executive will be in a position to determine what capital will be invested in the new foreign enterprise by the parent corporation. He may also be able to estimate how much capital will be borrowed from outside sources for the division. Finally, he will have a fairly good idea of what top management expects in the way of a fair return on invested or disposable capital.

All other investigations will have to be made on the basis of these budget figures. Once the foreign division is in operation and the initial warm-up stage completed, actual performance will then have to be checked against these budget figures.

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The Economic SCENE . . .

by W. Allan Beckett

NEEDED: MORE IMMIGRANTS?

"PEOPLE make the difference." So runs the slogan of one of Canada's larger chartered banks. No doubt the bank is using the term narrowly to define its attitude towards customers. But it is a well known fact that population growth in any country leads to a rising demand for consumer goods. It also leads businessmen to increase their expenditures on plants and equipment, both of which provide employment and income in the economy.

The dozen or so years since the end of World War II have constituted a period of tremendous growth in Canada and our high intake of immigrants to swell the labor force and also to consume goods and services has been a big factor in this expansion. Population increase, whether by natural growth of the native population or immigration, is closely related to the continuing health and growth of the Canadian economy. Since the war some 1,800,000 immigrants have come to our shores. During the same time our total population rose by about 5,350,000. In other words, one out of every three added to the Canadian population came from some other country.

THE FIGURES

The relevant statistics are shown in the following table covering to date the decade of the '50s.

RECENT POPULATION CHANGES

Year	Total population increased by (000)	Of which the natural increase is (000)	Of which immigration supplied (000)	[From which Canadians leaving must be deducted (000)	The labor force increased by (000)
1950	265	242	74	— 51	3
1	297	251	194	—148	137
2	450	265	164	— 21	98
3	386	279	169	— 62	76
4	442	302	154	— 14	96
1955	411	313	110	— 12	116
6	383	310	165	— 92	173
7	508	329	282	—103	221
8	459	340	125	— 6	124
1959	394	341	114	— 61	122 (est)
Annual Average	400	297	155	— 52	117

SOURCE: Dominion Bureau of Statistics.

POPULATION RISES AS EMIGRATION DECLINES

Contrary to widely held opinion, in the years in which population has taken a big jump, say by over 400,000, the increase has been due less to a marked rise in new arrivals than to a sharp fall in the number of Canadians leaving the country to live elsewhere. The sole exception is 1957 when both intake and outgo were unusually high with immigration so heavy as to cause a very large rise in population. Emigration tends to be high in boom times and low in recessions, presumably because these fluctuations in the business cycle occur in other countries at pretty well the same time as in Canada. The annual loss is no small item—for every three to four immigrants, one resident leaves the country.

IMMIGRATION AND THE LABOR FORCE

Much has been written about the economic effects—good or bad—of immigration. Some oppose immigration because immigrants are supposed to take jobs away from native sons. Others favor immigration because it swells markets. One thing is sure, each immigrant brings a pair of hands as well as a mouth. The impact of the influx of immigrants can be shown in relation to the labor force—after all, a rising Gross National Product or total output of goods and services can come only from an increase in the work force multiplied by an increase in output per man hour.

In the post-war era, Canada's labor force has increased on the average by a little better than 100,000 workers a year, i.e., a two per cent growth rate—interestingly enough the last four years, 1955-58 inclusive, have seen above-average growth and the same is likely for 1959. As might be expected, the big years of expansion in the labor force have been years of above-average immigration as is evident in the table. In 1957, for example, the labor supply in the country increased by almost double the post-war average. For the most part this was because immigration reached a point higher than anything seen since the early years of the 20th Century, when new settlers were flooding into the country to populate the Canadian West. This bulge, occurring as the pace of economic growth slowed, is still not completely absorbed.

HALF THE IMMIGRANTS ARE WORKERS

But only about one-half of each year's total immigration is an immediate addition to the labor force. In 1958 some 125,000 new arrivals entered the country and of this number 63,100 were workers and the remainder dependents. It is interesting perhaps that of the immigrant workers, 70 per cent were either sponsored by Canadian residents or were in the self-establishment category such as business executives and professionals. During a period of abnormally high unemployment, the immigration authorities were evidently making sure that the proportion of workers without immediate prospect of a job or assistance from relatives would be small indeed.

THE RED LIGHT GOES ON

The recession of 1957-58 brought a turning off of the tap, a normal occurrence since it is hardly sound economics or even fair play to immigrants themselves to continue allowing them to enter the country at a time when the economy is actually contracting and its ability to provide jobs steadily lessening. Last year saw an intake of 125,000, less than half that of the preceding year. and well below the recent

average of 155,000 per annum. Fortunately part of the adverse effects of falling immigration was offset by the lowest level of emigration in many years.

AND STAYS ON

What of 1959? This year has seen a continuing of the off-again part of our traffic light immigration policy. The nation's population estimates are made as of June and the figures for this year are therefore available. Total population is increasing in 1959 by slightly better than the average of the last decade. The reason is not to be found in either births or deaths of the resident population—the natural increase is well above normal. But immigration is down, only slightly above the 100,000 level. In many ways we seem to be repeating the 1955 experience when the influx of immigrants was sharply cut. To those who remember the acute labor shortages in the boom years which followed, the present parallel may cause concern to businessmen anxious to keep down their labor costs. As well, 1959 is seeing an above-average number of Canadians departing to other lands, one Canadian leaving for every two new arrivals, an unusually high rate of emigration.

TIME FOR A CHANGE?

A relaxation of the present restrictions seems highly probable—and soon—possibly an official announcement that the doors will be opened wide once again next spring. Presumably most immigrants need six months or so to make up their minds to come to Canada and then to get through the red tape blizzard. Judging by this year's performance, considerable leeway exists for sharply increased immigration if the promise of the decade of the '60s is to be achieved for Canadians. Our economy continues along the path of economic recovery; the unemployment picture is approaching normal and there are ample indications of an even bigger year in 1960. Hence the time seems ripe for renewed immigration. The increase in population each year from natural causes grows only very slowly. It is to immigrants that we must look for the additional labor force necessary to drive our economy to new peaks.

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IN DEFENSE OF HISTORICAL COST

By Clarence L. Dunn,
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In this article, the author argues for the retention of historical cost as the primary basis of accounting. Even if it were assumed that historical cost was outmoded by current cost from a managerial standpoint, he points out, there would remain the need for cost data for many other purposes, such as income tax computations and the solution of other legal and contractual problems where calculations based on invested costs are required.

THE major developments in accounting in this country during the last 50 years or so have clearly resulted from changes in economic and business conditions. In our economic development probably the most influential force was the growth of the large industrial enterprise which was accompanied by the substantial separation of ownership from management. There resulted a continually increasing need for objective standards of income measurement and a narrowing of alternatives in accounting practices. Cost, being an objective method of measurement and generally considered more useful than value for income measurement, became the generally recognized basis of accounting for assets and expenses. At the same time, significant changes in accounting philosophy and accounting emphasis have appeared, many of them directed toward more accurate, more scientific, and more objective income determination.

Criteria concerning the nature and extent of necessary disclosure have gradually been established and improved. Considerable attention has been given in the last 25 years to the definition and refinement of accounting principles. Accounting thought and practice, as new problems have arisen and been conquered, have taken on new horizons. There has been a process of gradual evolution and adjustment to meet the needs of the changing times and economic conditions.

Through this development, accounting thought and action have come to be well grounded upon basic concepts, conventions and assumptions. One of these, an interpretative assumption underlying the use of accounting statements, is that the dollar is a reasonably stable unit of measurement. But in periods of major price movements this assumption is clearly invalid for certain purposes. At such times the question of whether some adjustment of asset values is necessary almost invariably arises. In the past decade several writers, some of them accountants, have contended that enough of a change in the value of money has occurred to justify "a departure from cost" in reflecting asset "values," in recording depreciation, and in computing periodic income. Frequently these articles have carried a note

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of distrust or expressed forthright doubts of accounting reliability and the integrity of financial statements.

There have been plenty of implications and insinuations that present accounting practices which have "cost" as the fundamental basis for assets and expenses are behind the times and inadequate, and that they do not show correctly the results of business operations. Critics have claimed that accounting lacks realism and that drastic modification of its method of determining income is needed. Certainly such pessimism about accounting is bound to cause serious doubts about its usefulness.

Under the impact of price level changes in recent years, challenges have arisen as to the adequacy, for many purposes, of the conventional method of measuring net income. As conventionally measured, accounting net income expresses the excess of periodic revenue over the cost of the capital (resources) consumed in earning that revenue. The costs matched against revenue in this computation are, in general, the historical dollar costs—the kind of cost dollars initially invested. Some writers in explaining this have definitely challenged the validity of the "cost principle" in accounting by pointing out that the costs matched against revenue are being understated or that they are not being stated on a basis consistent with that of the revenue.

This article is an attempt to answer the question of whether historical cost is the most logical and natural basis to use in accounting for the "values" to be matched against revenue, even in periods of major changes in the value of the dollar. In other words, is the cost principle at the present time as valid and as useful as it has been held to be in the past when the purchasing power of the dollar was greater and more stable than in the past ten or twelve years?

WHAT IS "HISTORICAL COST"?

"Historical cost" means the amount measured by actual cash payments or their cash equivalent at the time of an actual outlay, or at the time a legal obligation to make a future outlay is incurred. The word "historical" points to the fact that the data in the accounts rest upon accomplished events. Such measures of cost are verifiable by records of transactions that have occurred or by commitments already definitely made. Historical cost, then, refers to the exchange price that resulted from a transaction which has transpired. However, there is more involved in the concept of historical cost than the mere recording of the acquisition prices of commodities or services received. The terms "historical cost" and "cost principle" as usually employed in accounting literature refer to the use of cost, as initially recorded, as a basis for making later transfers from one objective to another, from one classification to another, or from one process or activity to another.

COST IS OBJECTIVE AND VERIFIABLE

Probably the most important and most widely claimed virtue of the historical cost basis is that it makes possible determinations that are objective and verifiable. In recent decades there has been increased emphasis on objective and independent standards for testing the fairness of representations made in accounting reports. Certainly one of the major prerequisites which an acceptable accounting procedure should meet is that the data recorded be susceptible to objective determination and objective measurement, insofar as possible.

The emphasis upon objective evidence has never been weakened. This is because accountants have been striving to make the financial information presented in their reports more dependable and more reliable. In order to accomplish this they have necessarily required that the financial statements show facts rather than forecasts, and have preferred objectively determined data rather than subjective opinion. Emphasis upon objectively determined facts has been preferred so that accidental error, wishful thinking, biased self-interest, and intentional deception could be minimized. Verifiable, objective evidence has therefore become an important element in accounting, an element which can hardly be refuted if accounting is to perform its primary function—that of supplying dependable, authentic information.

The most objective accounting information is usually presumed to result from arm's-length transactions effected between entirely independent parties. The sincerity of their individual judgments has been proved by their action in backing them with valuable consideration and in completing the transactions. Cost determined in such transactions between individuals or enterprises free to bargain without coercion, other than the normal pressures of business life, is usually considered to be the best possible evidence of value at the time a transaction is entered into. At this moment in time, it may be said that cost and value are both objective facts to the particular purchaser. Later they may, and usually do, deviate considerably; then only cost remains as the objective accomplished fact. Value has changed, but cost to the enterprise has not. Furthermore, the inflowing facts of commodities and services acquired are generally well supported by objective evidence in the form of authentic business documents. There is definite proof that a certain price was paid, that a definite amount was invested. This is strong reason in favor of retaining cost as a measure of management's accountability for an asset.

It should not be assumed that accountants are never interested in information derived from subjective judgments. There are often situations where completely objective facts are not available at the time the accounting record must be made. Also, there are different degrees, or graduations, of objectivity. Not all accounting information can be completely objective. The materials with which accounting has to deal cannot be determined with complete and conclusive objectivity at all times. But to be very dependable the facts should be convincingly objective. The facts relating to the cost incurred by an enterprise for an asset investment will usually be convincingly objective; they may even be conclusively objective. The subsequent accounting treatment of recorded facts, being more directly under the influence of a variety of theories and more dependent upon management opinions or decisions, often rests upon evidence that is less than conclusively objective.

It seems clear that the evidence supporting cost, and the evidence supporting the process of separating the charges of revenue from the unexpired balances using cost as the basis, is verifiable and objective to a high degree. Objective determination, therefore, is certainly one of the strong points in the case for historical cost.

COST IS CONSISTENT

A second major requisite of an acceptable accounting procedure is that it shall be susceptible to consistent application from year to year. This does not mean that

a desirable change in procedure is ruled out. But it does mean that a procedure should not be adopted with the premeditated intention of influencing the results of one year, or of several years, then be abandoned in favor of another plan merely because the situation has changed.

A wholesome viewpoint, one conditioned by a strong desire to make accounting information as useful as possible, does not exclude consideration of changed conditions. Accounting is evolutionary. Accounting theory, and with it accounting practice, changes with changing conditions and varying demands on accounting information. Consistency should not impede change in accounting procedures when such change is the logical and proper consequence of the altered conditions. Consistency is significant because it sifts proposed changes to find those which will be mutually consistent and which will best fit into the existing body of accounting theory; it stands as a temporary barrier to fast action on proposed changes.

Consistency does not mean that everything must be done this year in precisely the same way as it was done last year and the year before. There would be no real progress here, no chance for improvement, if such a narrow viewpoint were adopted. The best viewpoint of consistency in accounting is that a reasoned caution should be exercised when pressures for changing accounting procedures are put forth. There must be constant vigil as to where improvements in accounting procedures and techniques are necessary and how such improvements may be implemented. Consideration should be given to the consequences not only in the short-run but over the long period of time. The wisest judgment is generally not entered into on the basis of short-run considerations only. There must be an air of open-mindedness in the appraisal of proposed new accounting methods and procedures, but the doctrine of consistency lends a definite caution to this open-mindedness. Such caution should help to guard against changes that are likely to lead to bad practices. Consistency implies that there are no unwarranted changes which in themselves will create a host of new accounting problems.

In the past much importance has been given to the opinion that accounting for assets and expenses should be an orderly process, and should result in reasonably consistent practices. Has the accounting for assets and expenses on the basis of cost kept pace with the development of the doctrine of consistency? It seems clear that such has been the case. This is true because the pressure to be more consistent has stemmed from the desire to be more logical and orderly in accounting for assets and expenses. Heretofore, the possibilities of being orderly, of having continuity of accounts, and of being objective, have appeared greatest where the accounting has been based on historical cost.

Another point in favor of the cost basis of accounting, when considered as the starting point for the accounting record, is that cost, in itself, is consistent. Cost is not an arbitrary amount; it is an accomplished fact. As a starting point for later determinations, cost is a known, unwavering basing point. Beginning with such a basis, the inconsistencies that do creep in through mistake or intentional change in procedure are more readily recognized and explained.

COST AS A BASIS FOR INTERPRETATION AND REPORTING

There must be a starting or anchor point in the accounting record for subsequent interpretation and reporting. No serious objections have been put forth

concerning the use of cost as that starting point. At the time of acquisition of an asset it can be said that cost and value usually are substantially the same. In a great majority of transactions, the most dependable measure of the fair market value of assets at the date of acquisition is the price actually paid. It does not matter much whether the purchaser calls this his cost or the value of the asset. Both are significant; cost is significant because it represents or approximates fair market value at date of acquisition. Cost, at the outset, represents the investment made. It is, therefore, the primary factor which it has always been the function of accounting to report—to report the investments made and what subsequently happened to them in the operation of a going concern.

Although cost does not necessarily represent value at a date subsequent to acquisition, this does not mean that cost should be of no concern and perhaps be discarded in favor of some other basis more closely measuring value. A better viewpoint is to hold that invested costs, having once entered an enterprise, can be changed in only two ways: (1) by the exit of that investment from the enterprise, or (2) by the manipulation of the investment facts under a theory that the value, not the investment cost, of an item reflects its real accounting significance.

Proponents of the historical cost basis urge that invested cost is the primary fact and therefore should not be submerged or discarded. If that is done, investment is completely lost to sight as part of the basis for financial decisions. Throwing away one half of the available facts can hardly be the most satisfactory basis for decisions affecting the present or the future. It is not correct to say that the fact of invested cost has no bearing on these decisions. Management must be able to review its prior efforts, and the best record of those efforts is bound to be based on invested cost. Cost, to management, represents decisions carried out and investments made. In making those investments certain risks were involved. In order to judge, in retrospect, the wisdom of having entered upon those risks, management dare not lose sight of their investments as risked costs. Such appraisal of prior decisions, if it embraces objective data identifiable with specific prior decisions, can be a substantial factor when management faces decisions concerning similar future actions.

COST AS A BASIS FOR ACCOUNTABILITY

There is also a strong argument in favor of retaining cost as a measure of a company's accountability for assets. There is a strong presumption in favor of cost for the record of the investment in the assets for which management is to be held accountable. The present value of the assets is important, especially in the face of impending replacement, in the planning of adequate insurance coverage, and in making decisions between alternative actions in various situations. As a measure of accountability, however, the *quantum*, or number of dollars invested in the capital assets, is of primary importance.

COST AS A BASIS FOR MANAGEMENT GUIDANCE

Accounting is not an end in itself. It serves a useful purpose only insofar as it furnishes management with the guidance to plan, to control, and finally to evaluate the results of operations. Accounting based on historical cost can supply only part of this information. The simple fact is that no single set of figures, prepared on any basis, whether in the accounts or elsewhere, can possibly record all of the

varying measurements of past results and current position which can be applied by those various parties who might use the information. Almost every aspect of accounting permits alternative bases of measurement. Accounting, it is said, is utilitarian; it is a practical art. Practicality must therefore play a large part in accountants' choices of ideas and methods. Accounting must be satisfactory in the light of everyday experience and capacity for use, in the light of methods that are attainable, and of ideas that are acceptable to many users. In order to accomplish all of this within the present scheme of accounting methodology, it would appear that some one basis of accounting must be selected as predominant, as best representing the factor of greatest significance for all-purpose use.

This does not mean that other information lacks usefulness. It is well known that management does not attempt to make decisions concerning the present and the future solely on the basis of accounting data. On the other hand, management cannot make the most dependable judgments under guidance of non-accounting data alone. In many cases numerous adjustments and interpretations will have to be made. This will be true whether historical cost is the basis for the accounting record or whether some other basis is employed. Management will continue to know that sometimes value information is required to judge for the future, and that sometimes cost information is required if they are best to discharge their responsibilities. Invested cost is the most logical starting point in the accounting record for these subsequent adjustments and interpretations.

Although the determination of cost may involve many problems, it is nevertheless true that recording under the cost basis is clearly less difficult than recording on the basis of value. This is an advantage of the historical cost basis with definite practical significance. Recording on the cost basis, and adherence to the cost basis thereafter, eliminates the necessity of frequent and periodic appraisals, which concededly are difficult matters and which are apt to be inexact. This does not mean that a company should never have appraisals made. They would be very beneficial to most companies as a guide in planning for insurance and for replacements, if for no other reasons. If the accounting record were to be based on appraisal values, however, it would mean in most cases that a program of almost continuous and very detailed appraisal would be necessary. This would be extremely expensive and probably would give end-results no more dependable and no more desirable than are obtained at present under the historical cost basis.

COST AS A BASIS FOR INCOME TAX RETURNS

Another point in favor of the historical cost basis is that records kept on this basis facilitate the preparation of income tax returns under the present laws. There are many areas of inconsistency between income tax requirements for corporations and generally accepted financial accounting procedures. There are numerous instances where the most desirable income tax treatment would vary from the most appropriate accounting procedure. It can usually be expected that the figure of taxable net income for the year will vary considerably from the figure of book net income. Nevertheless, in the process of income tax determination, there has been a reluctance to allow any type of value judgment, especially future value judgments. Depreciation based on expected future replacement value has never been sanctioned.

Inventory losses based on possible future decline in inventory value may not be charged as deductions against current year's gross income. Other charges made against current income by corporations to provide reserves for future expenditures have been disallowed time and time again. Until and unless a rather complete change in tax philosophy is accomplished, something which appears to be remote, it is certain that accounting based primarily on historical cost will continue to hold the most favor in the eyes of the income tax officials.

COST FACILITATES RECORD KEEPING

There can be no denial that the bookkeeping under the historical cost basis is the most convenient method yet devised. The present scheme of accounting methodology is especially well-fitted to accounting for acquisition cost, cost regroupings, and cost transfers. In nearly all cases where departures from the cost basis have been involved, some special procedures have had to be devised in order to bring the additional information into the double entry accounts. Primarily this difficulty has resulted from a desire to show the additional information in the accounts and at the same time to preserve the cost data. In attempting to show the "lower of cost or market" for inventories, for example, the two-fold aim of showing both cost and the lower cost-or-market valuation has been accomplished by showing the inventory cost in one account and the difference between these two amounts in a special reserve account. Quite similarly, the problem of recording fixed asset appraisal values while preserving the cost basis information has been accomplished by using special accounts for the revaluation increases and special procedures for handling subsequent depreciation. In both of these examples, however, the utilization of the additional value information has been secured by using special accounts and procedures, not by attempting to revise the entire scheme of accounting methodology.

Problems do arise in the recording for assets and expenses under the historical cost basis. For example, a decision which must be made time and time again concerns the determination of whether an expenditure is a capital or a revenue expenditure. But for the purpose of making the original record it is difficult to see how any other basis adopted to account for assets and expenses could be more convenient or easier to apply than the historical cost basis.

The point of convenience and ease of application also applies to subsequent determinations and adjustments which must be made after the original recording. Under the historical cost basis, the accountant starts with a known basing point. The sands are not always shifting when cost is the basis. It is true that the value of the dollar has changed, and cost is measured in this currency unit. Our currency is not fixed, but business transactions are carried on every day with it, the transactions are discussed and even recorded with it. The truth is that our financial world is without any basically fixed frame of reference. Would it help if the frame of reference were shifted from the currency unit to its purchasing power? Then nothing would be fixed. Changes in purchasing power and in value are almost constantly occurring. Accurate, dependable determinations of revenue charges would probably be a costly and multifold process.

OTHER CONCEPTS UNDERLYING COST BASIS

Behind the concept of historical cost are many other concepts and conventions. One of these is the concept of "profit." It is claimed by the defenders of the historical cost basis that the profit determination resulting from the adherence to the historical cost basis is in conformity with the layman's idea of profit. The traditional accounting idea is that profit is the excess of revenue, proceeds, or selling price over related costs. To the layman, the general idea is similar. If an asset which cost $10 yesterday is sold for $15 today, there is a $5 profit, even though it may be known that the seller will have to re-invest $12 tomorrow to obtain another like item. The $12 re-invested in the new asset is generally thought of as a new investment. Whether a profit will be made from its sale depends upon its selling price in the future.

Closely associated with this idea is another which holds that a profit is not made until the asset or service is disposed of and the revenue received. Until that point in time, the best that can be said is that there may have been an unrealized increment in the value of the asset or service. In ordinary accounting parlance, income is realized at the time of sale and is the excess of the selling price over the cost of the item sold. A completed transaction for accounting recognition of profit is usually considered to be a purchase or other acquisition followed by a sale or other disposal. Any increase or decrease in the value of the item sold is presumed to be reflected in the selling price. Only at the time of sale is the measure of value, as a basis for the accounting record, objectively and definitely known. Included in the cost of the item sold is the acquisition of the item in its acquired form plus the direct and indirect production costs, including the depreciation allocation, but changes in value are not considered to affect the calculation of cost.

Another basic idea which is generally held is that the person or group of persons accountable for an asset are accountable for the investment in the asset, and this investment is measured by the unamortized cost of the asset. The mere fact that the value of the asset has increased does not increase its accountability. Accountability is increased through accretion, but not by appreciation in value. To say that managers shall be responsible for increases in value not measured by completed transactions except in the case of accretion, is to say that they must bear the risks not only of actions under their control, but also of phenomena and outside influences not under their control and which a prudent management often cannot foresee.

The advocates of the historical cost basis urge that continued adherence to cost would not require a modification of basic concepts painstakingly developed over a long period of time. On the other hand, they urge that the thorough-going use of some basis other than cost would require that new concepts be developed or that many basic concepts presently held be revised. Furthermore, they maintain that such revision is unnecessary and might be confusing or misleading and even contrary to the general ideas held to be self-evident in our society.

CONCLUSION

The basic conclusion of this article, therefore, is that in spite of changes in the price level, whether they be upward changes or downward changes, the significance of historical invested cost is such that the cost basis should be retained as the

primary basis of accounting. Other data may be brought into the accounts but this should be accomplished without obscuring the recorded cost data. There seems to be no justification for complete submergence of costs incurred, and the subsequent transformations and allocations of cost, in a continuing enterprise. Even if it were assumed that historical cost was outmoded by current cost from a managerial standpoint, there would remain the need for cost data for many other purposes, such as for income tax computations and for the solution of other legal and contractual problems where calculations based on invested cost are required.

The emphasis upon the cost basis does not deny that data other than recorded costs may have real significance and usefulness. It merely rejects the proposition that periodic revaluation, or conversion of recorded dollar cost into current dollar values, has a settled place within the regular accounting framework. Furthermore, in making any attempt to meet in the accounts themselves, the difficulties raised by the use of a variable measuring unit, the accountant is embarrassed by the fact that the law, in general, does not acknowledge the existence of the problem. At the same time, the accountant should realize that he is being relied upon more and more to disclose in some way the essential economic developments and conditions attaching to the enterprise for the purpose of meeting the needs of investors and managers. He cannot afford to ignore completely any line of attack which promises to enable him to fulfill this broad function more adequately. The best solution at the present time appears to be the presentation of special interpretative reports supplementing the primary financial statements and designed to trace the main effects of general price movements upon the affairs of the enterprise.

PERSONALS

J. C. HUTCHESON, R.I.A., was recently appointed Office Manager and Accountant of Oakville Wood Specialties Ltd. Mr. Hutcheson is a member of the Niagara Chapter.

G. A. ELLIOTT, R.I.A., a member of the Niagara Chapter, has been appointed Assistant Secretary of Foster Wheeler Ltd., St. Catharines.

N. G. MISNER has been appointed Secretary Treasurer of Cyanamid of Canada Ltd. Mr. Misner is a General Member of the Niagara Chapter.

T. D. BEVAN of Windsor has been appointed Controller of R. P. Scherer Limited.

W. M. CURRAN was recently appointed General Works Accountant of The Steel Company of Canada Ltd. Mr. Curran is a General Member of the Hamilton Chapter.

F. W. GIBSON, R.I.A., was recently appointed Manager of Jessiman Motors Ltd., Port Arthur. Mr. Gibson is Chairman of the Lakehead Chapter.

L. H. DENSMORE, R.I.A., of the Niagara Chapter, has been appointed Assistant Secretary of his company, Hayes Steel Products Ltd., Merritton.

G. DORESCO has been appointed Assistant Treasurer of Hayes Steel Products Ltd., Merritton. Mr. Doresco is a member of the Niagara Chapter.

C. I. ALLEN, Vice-President and Secretary-Treasurer of the Canadian Locomotive Co. Ltd., Kingston has been given complete responsibility for the operations of the company.

W. J. WRIGHT of the Toronto Chapter has been appointed Assistant Comptroller of Salada-Shirriff-Horsey Ltd.

Books in Review . . .

DECISION-MAKING AND PRODUCTIVITY

By Seymour Melman, New York, John Wiley and Sons, Inc., vii 260 pp - $7.00

Reviewed by C. G. Edge, R.I.A.

There is a natural tendency to think of high productivity in industry being achieved solely by the ability of management, and that the intensity and cost of management control increases with mechanization. Professor Melman, in this book, demonstrates that these premises are not necessarily true and that union and workers can successfully participate with management in the decision-making process.

The strengths and weaknesses of this mutual decision-making process, in which management seeks to maximize earnings and workers to maximize their take-home pay, are illustrated in the post-war experience of the Standard Motor Company, one of the Big Five automotive producers in the United Kingdom.

The features of the system were the method of production organization and the allied system of wage payment. Workers were grouped in "gangs" and management kept track of only the finished output of the gangs. The gangs were as large as feasible—one contained 3,000 men—and there were no supervising foremen in the accepted sense of the term. An incentive wage system, in which the bonus was equal to about one-half of the take-home pay, was based on the output of the gang as a whole.

From the management point of view, the system resulted in a high and balanced utilization of equipment and hence high productivity, low cost of management because of less supervision, low employee turnover, and less resistance to mechanization.

From the point of view of the worker, the wages paid were substantially greater than those in other automotive companies and in industry generally. This was due more to the effective utilization of labor than to greater effort expended per worker.

The drawbacks to the system appeared to be due to the risk of political interference and the inability, at that time, of the union and workers to cope with unusual and major problems. Unions in England are more closely allied with political parties and if the unions become Communist-dominated, then the decision-making process may become perverted for political ends. Furthermore, the successful operation of the system at the Standard Motor Company appeared to be due, despite hard bargaining on both sides, to the mutual respect of management and workers. When this confidence was jeopardized by a major model change, resulting in lay-offs and increased automation, the union relinquished its responsibility for decision-making when the inevitable results would have been unpalatable to the membership.

Professor Melman has given a fascinating insight into successful manager and worker co-operation in one of the largest automotive producers in the United Kingdom.